

## Module IV: Understanding the Basics of Banking

### Introduction to the Banking World

• **Summary:** *On December 23, 1913, an Act of Congress created the Federal Reserve System, which serves as the Nation's Central Bank. The System consists of a seven member Board of Governors with headquarters in Washington, D.C., and 12 Reserve Banks located in major cities throughout the United States. The Federal Reserve System was created in order to stabilize the country's chaotic financial system and regulate our banks. Many federal and state laws have been enacted in order to promote and enhance a competitive banking structure that in turn serves the public interest. The banking system is always evolving and banks are aggressively competing for your dollars. New technological advances are making the financial services industry very competitive. Banks offer a variety of services and products, but only you can decide which bank is best for you. This module will help you understand the basics of banking to allow you to be better informed as you research all the different options available to you. So, let's begin our journey into the world of banking...*

The links below provide quick access to the specific sections of this module that may be of particular interest to you.

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The chart below provides a quick summary of the pros and cons associated with the major types of banking institutions:

### Banking Choices

Banks	Pros	Cons
<b>Commercial Banks</b>	Serve individuals and businesses; multiple branches, offer full range of banking services; deposits are FDIC* insured	<ul style="list-style-type: none"><li>•Fees are generally high</li><li>•Service can be impersonal</li></ul>
<b>Credit Unions</b>	Fees and loan rates are lower; many credit unions pay out earnings to members at the end of the year	<ul style="list-style-type: none"><li>•Not all are FDIC insured</li><li>•Membership is restricted to a certain type of group</li></ul>
<b>Private Banks</b>	Provide individualized financial services; personal representative handles all your banking needs	<ul style="list-style-type: none"><li>•Usually pay an annual fee</li></ul>
<b>On-Line Banking</b>	24 hour access to your account; most are FDIC insured; no waiting in long lines; handle transactions from your home computer	<ul style="list-style-type: none"><li>•Service can be impersonal</li></ul>

\*Federal Deposit Insurance Corporation (FDIC) - guarantees each bank depositor against losses of up to \$100,000 (per bank where depositor has funds) in the event of bank failure.

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### Banking Services

#### Checking Accounts

Checking accounts vary from bank to bank. Some banks offer free checking, while other banks offer checking with a low monthly fee. The key to choosing a checking account is to evaluate the options. If you look around at different banks, you will more than likely be able to find a free checking account. However, free does not always mean better. The following discusses the major components of a check:



**Check Number** (located upper-right corner) - Makes your record-keeping easier.

**Pay to the Order of** - Name of person or company check is made payable to.

**Amount to be Paid** - Written in both numbers and words. If the two don't agree, *the words take precedence!*

**Routing Number** (located bottom-left corner) - this identifies your bank. Every bank has a different routing number.

**Account Number** - The account number identifies your account, so that transactions are recorded accurately.

**Check Number** (located bottom-right corner) - These numbers allow bank computers to read the check in order to process and record your transaction.

**Note:** When you receive your checks from the printer, make sure that your routing and account numbers located at the bottom of the check are accurate!

### **Direct Deposit**

Most people look forward to payday, but nothing is more aggravating than taking your paycheck to the bank, standing in lines for half your lunch break to deposit your check, and still not have your funds available to you until the next "business" day. Direct Deposit has revolutionized the banking industry. With direct deposit, your paycheck is electronically credited to your account and is immediately available to you. This is also known as "Sure Pay."

### **Automatic Teller Machines (ATMs)**

Payday has passed and you want to access your money. There are several ways that you can access your money. The most common way people access their money is from automatic teller machines, more commonly known as ATMs. Most basic banking transactions can be done at ATMs. Such transactions include: withdrawing cash, depositing checks (only if the ATM belongs to your bank), transferring money, and checking your account balance. It is very common to have your ATM card linked to both your checking and savings account. [Many banks charge a small fee for non-customers to access their accounts through an ATM.] ATM cards were just the beginning of what was to come.

### **Check/Debit Cards**

Check/Debit Cards look like credit cards and are usually accepted where major credit cards are accepted. Check/Debit Cards have revolutionized the whole check-writing world. When you use your check/debit card, the funds are taken directly from your checking account, just as they would be if you had written a check. [Unlike credit cards, these cards do not provide “purchase protection insurance.”]

### **Automatic Bill Paying**

Automatic bill paying has become increasingly popular over the past several years. Automatic bill paying takes funds directly from your account and electronically transfers those funds to the payee. The table below highlights some of the advantages and disadvantages of automatic bill paying:

<b><u>Advantages</u></b>	<b><u>Disadvantages</u></b>
<ul style="list-style-type: none"><li>• Pay bills on time, every time</li><li>• Payments are scheduled automatically (usually for the same amount each month)</li><li>• Save money on stamps, envelopes, and late fees</li><li>• If you get deployed, payments will still be made</li></ul>	<ul style="list-style-type: none"><li>• Some banks charge a monthly fee</li><li>• If there is a discrepancy on your bill, the money will still come out of your account until the discrepancy is resolved</li><li>• Requires additional planning to stop or change payment amount</li></ul>

### **Overdraft Protection**

When you write a check and do not have enough funds in your account to cover that check, your check “bounces.” As a soldier, this could have serious consequences for you, so why not protect yourself? With overdraft protection, a check will be automatically paid even if you do not have sufficient funds in your account at the moment.

One type of overdraft protection is sometimes called line of credit or credit line. This line of credit is linked to your checking account and can be used in more than one way. Not only will the line of credit protect you up to your credit limit against bounced checks, but it can also be used as emergency funds. For example, you could withdraw money from your credit line without even touching your bank account funds. You can decide how much line of credit you want to apply for; however, there is a catch -- do not forget to pay your monthly fee on your line of credit!

Another type of overdraft protection does not require you to take out a line of credit. A common way to protect yourself from bouncing checks is to link your checking account with your savings account. With this type of overdraft protection, when a check is going to overdraw your checking account, funds are automatically transferred from your savings account to cover that check. Just be careful when using this feature because some banks might charge you a small fee every time funds have to be transferred.

### **Provide Other Types of Check Services**

**Cashier Checks** - guarantee that the check is good because it is drawn against the bank's account. Cashier checks are not the same as certified checks. When you get a cashier check, you pay cash for the check. Some banks charge a small fee for this service.

**Travelers Checks** - are used in place of cash in places where personal checks are not accepted. The good thing about Travelers Checks is that you can buy them in various fixed amounts. There is usually a small fee associated with this service also. Most banks charge \$.50 to \$1.00 per \$100 that you purchase. The advantage to Travelers Checks is that if the checks are stolen, you can get them replaced immediately by simply calling the issuer.

**Certified Checks** - are personal checks that your bank guarantees it will honor.

**Money Orders** - these are good to use if you do not have a checking account. Money orders usually include a small purchase fee, but are as good as cash. Money orders can also be purchased at your local post office.

### **Saving Accounts**

A savings account is an account on which interest is paid. Traditional savings accounts are no longer the trend of the 21st century. The interest rates offered on traditional savings accounts do not compare to those rates offered from Certificates of Deposit, stocks, bonds, mutual funds, or money market accounts. However, a savings account is a safe place to keep your emergency fund and cash you will need in the short term.

### **Certificate of Deposits (CDs)**

A Certificate of Deposit, commonly known as a CD, is a written acknowledgment from a bank that it has received a specified sum of money as a deposit from the person named. CDs last for a fixed term at a specified interest rate. Before buying a CD, make sure that you shop around. Many banks offer special deals on CDs, but it is all in the timing. You can get a CD for as short as 3 months to as long as 60 months. The table below outlines the rewards and risks associated with investing in CDs:

<b><u>Rewards</u></b>	<b><u>Risks</u></b>
<ul style="list-style-type: none"><li>- The interest rate is higher than for typical bank accounts</li><li>- You pay no charges for a bank CD</li><li>- Changing economic conditions do not reduce what you earn</li><li>- Your bank investment is insured up to \$100,000</li></ul>	<ul style="list-style-type: none"><li>- Your money is locked in at a specific rate, even if interest rates go up</li><li>- You will pay a penalty charge for early withdrawal of the money in your CD</li><li>- The new interest rate may be lower when it is time for your CD to roll over</li></ul>

The following is a listing of Key Terms often used to describe the characteristics of CDs:

**Annual Percentage Yield (APY)** - what return you actually earn on your CD; yield depends on whether interest is simple or compound.

**Simple Interest** - paid only once a year.

**Compound Interest** - can be paid in a variety of ways, from daily to monthly or semi-annually.

**Roll Over** - once your CD has matured you must decide what you want to do with the CD. If no action is taken on your end, the bank will automatically reinvest your CD usually for the same term, but at the new interest rate available at the time the roll over takes place.

### **Money Market Accounts**

Money Market Accounts offer competitive interest rates. Many money market accounts offer flexibility in depositing and withdrawing funds on demand. The rates in money market accounts are not guaranteed for any length of time, but are adjusted up and down with the market rates. Currently, various Internet sites and many market financial magazines monitor banks and will occasionally list those banks that offer you the most competitive interest rates. So before settling on a money market account, do your homework.

### **Investments**

Banks have gone from offering just the traditional savings account to offering accounts that provide a greater return for your money, but with greater risks. Banks now offer IRAs, Mutual Funds, Stocks and Bonds. These investments are discussed in other modules.

### **Loans**

A loan is a sum of money borrowed at a particular interest rate. Loans generally refer to anything given on condition of its return or repayment of its equivalent. A bank loan is usually made on collateral. Collateral is something of value given or pledged as security for payment of a loan.

Collateral usually consists of financial instruments, such as stocks, bonds, savings, or a particular piece of property.

### Auto Loans

Almost all banks offer auto loans. You can choose from a variety of auto loans and repayment terms. The interest rates on auto loans fluctuate. Most banks will allow you to choose from a variety of repayment plans. The key is to pick the repayment plan that will best suit your budget. The major factors that determine how much your monthly payments are going to be are: down payment, length of your loan, and your credit rating (which impacts your interest rate on the loan). Let's look at some examples. The following provides an example using two repayment plans:

#### **Generic Motors**



**Price:** \$29,800  
**Model:** GM 3.14 Pi

<u>Repayment Plan A</u>	<u>Repayment Plan B</u>
<b>Amount Financed:</b> \$29,800	<b>Amount Financed:</b> \$20,000
<b>Length of loan:</b> 84 months (7 years)	<b>Down Payment:</b> \$9,800.00
<b>Credit Rating:</b> Fair	<b>Length of loan:</b> 60 months (5 years)
<b>Interest Rate:</b> 9.24%	<b>Credit Rating:</b> Excellent
<b>Loan Payments:</b> \$483.09	<b>Interest Rate:</b> 7.74%
<b>Total of All Payments:</b> \$40,579.56	<b>Loan Payments:</b> \$403.04
	<b>Total of All Payments:</b> \$33,982.40

When looking at these examples consider each of the different variables involved. One key thing that will make a difference in the long run is the total of all payments. Most banks should be able to calculate “what-ifs” for you, so you can determine what payment plan best suits your needs. The more money you are able to put down for the purchase and the better your credit rating, the less money you will pay for the car in the long run.

### Signature Loans



A signature loan is a loan that is unsecured (meaning you do not provide any collateral to back up the loan in case you default on your payments). These loans can be used for just about any purpose. The terms of these loans will vary based on what you want the money for and how much you want to borrow. These loans are not offered at every bank. Signature loans are generally subject to higher interest rates.

### Mortgage Loans

Finding a mortgage loan can be the most challenging part of buying a home. Mortgage loans are a lot more complicated than other loans. In order to get a mortgage there are several steps that must be taken. A mortgage is a standard legal document that describes your agreement with the lender, the property itself and the amount of the mortgage. Mortgage loans are usually made for very long terms. The same factors that are considered for auto loans should also be considered for mortgage loans. However, as a member of the military you do have the advantage of a Veterans Affairs (VA) Home Loan. The principal advantages of the VA loan are lower interest rates, smaller down payments, and no prepayment penalties. We highly recommend you take advantage of the benefits of taking out a VA Home Loan when you purchase a home.

The following provides a short comparison between secured and unsecured loans:

### Secured versus Unsecured Loans

Secured Loans	Unsecured Loans
<ul style="list-style-type: none"><li>•Put up collateral or some type of security to guarantee loan repayment</li><li>•Lender can sell collateral when you fail to repay</li><li>•Lower interest rates</li></ul>	<ul style="list-style-type: none"><li>•Promise to repay</li><li>•Only requires your signature</li><li>•Co-signer might be required in case you fail to repay and then they will have to repay the lender</li><li>•Higher interest rates</li></ul>

### Final Thought

The banking world has come a long way since it's creation, and there is a lot more to come. Banks are no longer just a place to keep your money. They are expanding their product lines and offering a broad range of services. You now have a basic knowledge of the banking world, but for

those of you who want to expand your knowledge, we have listed below some good references for obtaining more information.

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## **References**

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